Food & Marketing

Marketing Fees Reflect Relationship Between Suppliers & Supermarkets

Since the time of the first national supermarket chain (A&P) in the 1920's, supermarket retailers and their suppliers (distributors or manufacturers) have conducted business creatively. For instance, the longstanding tradition of manufacturers presenting retailers with samples of new products can be traced to the early 1920's. During the last two decades, provisions incorporated into supplier-retailer arrangements have moved well beyond free samples to include provisions for adjustments such as rebates, shelf-placement fees, and advertising allowances.

Such adjustments—referred to as marketing fees—can affect consumer prices, profitability of the firms, and structure of the industry. Most of the adjustments can be categorized as lump-sum payments from suppliers to retailers or per-unit allowances granted to retailers by suppliers.

The use of fees is controversial, particularly because growth in their usage appears to coincide with a wave of supermarket mergers. Some comments that reflect differences of opinion about the growing use of fees and the potential results include:

- mergers have given retailers market power over suppliers, and fees are the result of this market power;
- fees undercut competition and reduce consumer welfare by reducing output, increasing prices, or slowing product innovation;
- growth of new product offerings exerts enormous pressure on a limited amount of shelf space, and fees serve to allocate shelf space; and
- fees reflect the increasing costs of retailing.

This article presents an economic rationale for marketing fees and explores possible impacts on consumers. It describes three types of fees commonly used in supplier-retailer transactions, examines the effects of pricing strategies or fees on competition, and assesses the potential economic impacts of fees.

Fees Serve Many Purposes

Specialized fee agreements between suppliers and retailers have been developed to accomplish a wide variety of purposes. Some fees are fixed payments, while others vary with the quantity exchanged in the transaction or with some aspect of retailer performance—e.g., volume of sales of a particular product. The most controversial fee is the "slotting" fee, a lump sum paid by suppliers to retailers for introducing new products to supermarket shelves. Although slotting fees were first introduced to supermarket retailing in 1984, tracking their history is nearly impossible since fees are negotiated privately and terms of transactions between retailers and suppliers are confidential.

The limited information that is available on slotting fees comes from the trade press, which presents conflicting reports on how frequently slotting fees are used. One source, market researcher ACNielsen, suggests that about $930 million—or 4.2 percent—of the $22.2 billion spent on trade promotions for products in 1987 was paid as slotting allowances. In contrast, another source, Freeman and Meyers, estimates that slotting fees in 1987 totaled $6-$9 billion.

"Pay-to-stay" fees are similar to slotting fees in that they are lump-sum payments made to retailers, but suppliers use pay-to-stay fees to keep existing products on the shelf. Other examples of fees are "hello" or "street" money, paid to grant a supplier an audience with a retailer to pitch a new product; advertising or promotional allowances—either lump-sum or per-unit payments—to advertise the suppliers' products; and supplier-paid volume discounts or rebates that may increase with the volume sold.

Fees can have both short- and longrun impacts on the grocery industry. Shortrun effects stem from changes in prices and product variety. In the long run, fees potentially affect entry of new firms into the industry and the pace of new product innovation.

Increasing use of fees may enhance consumer welfare in the short term if prices fall or product variety increases, and in the long term if the fees do not restrict entry of new firms into the industry and if innovation is not stifled. However, consumer welfare may decline if the reverse holds. The outcome for consumer welfare depends largely on the balance of negotiating power between retailers and suppliers.

Economic Impact of Fees

Slotting fees, pay-to-stay fees, and per-unit rebate with volume incentives differ in purpose and impacts on firms and consumers. These fees may also be associated with different types of products.

Slotting fees. To analyze the effects of slotting fees, researchers typically assume that supermarkets have a limited supply of shelf space with many new products vying for display. They want to sell only successful products, but consumers' acceptance of any new product is uncertain, making the risk of new product failure unknown. Product innovators, through extensive market research and product testing, generally have information about consumer acceptance of the new product, but retailers are assumed to be less informed about product desirability and potential consumer acceptance.

A positive aspect of slotting fees is that they may sort out products most likely to gain consumer acceptance from those that are less likely to succeed in the marketplace. Manufacturers may offer to pay retailers a slotting fee for a new product to indicate their confidence that consumers will buy it. Retailers for their part may solicit slotting fees from manufacturers based on their assumption that only manufacturers of products deemed likely to sell would be willing to invest in a product by paying slotting fees. Slotting fees also help to spread the risk of new product failure across many new products, diminishing the potential impact of loss from any one product.

Slotting fees have potential impact on both supplier-retailer and retailer-consumer relationships. Turning first to the supplier-retailer relationship, the procompetitive perspective is that slotting fees appear to make it possible for new products to enter the market, thus benefiting consumers through increased variety or quality of products. In contrast, the anticompetitive perspective is that slotting fees are the result of retailers wielding their power to extract lump-sum payments from suppliers.

Regardless of whether slotting fees are pro- or anticompetitive, the fees may affect wholesale (supplier-to-retailer) prices or supplier solvency. If the supplying industry is competitive, prices that retailers pay to suppliers tend to balance revenues with suppliers' costs. When competitive suppliers begin paying a fixed slotting fee, costs and thus wholesale prices could rise, so that, in effect, retailers may pay higher prices to compensate suppliers for paying the fixed fee. On the other hand, if suppliers operate in a market that is not competitive, it will be possible for supplying firms to remain profitable without increasing the wholesale price paid by the retailer. In either case, the higher costs prompted by the slotting fee may cause some suppliers to exit the industry.

The net effect of fees on consumers (the retailer-consumer relationship) is complex and difficult to assess because of variations in structure and behavior along the food marketing chain. Wholesale prices partially determine consumer prices, which depend on retailers' costs of purchasing, transporting, warehousing, and selling grocery items. Another factor in consumer prices is degree of competition among local supermarkets. Consumer prices would rise if retailers could pass the higher wholesale price along to consumers. Alternatively, competition among local supermarkets might prevent retailers from raising consumer prices.

The actual effect of slotting fees on consumer prices is uncertain. A study conducted at the University of Chicago indirectly explored slotting fees using publicly available aggregate data on industry sales, number of products, and price indexes. The study suggests that use of slotting fees can lead to a fall in consumer prices and a rise in product variety. A Marketing Science Institute survey, however, indicates that both manufacturers and retailers believe that consumer prices increased as a result of slotting fees. Research efforts have been hampered by the unavailability of proprietary information—i.e., detailed transaction-level data that include quantities sold, prices, and fees paid.

Pay-to-stay fees. Like slotting fees, pay-to-stay fees may cause consumer prices to rise or fall. Unlike slotting fees, pay-to-stay fees are not used to transmit information on consumer acceptance from supplier to retailer, since the product is already known in the marketplace from retail sales data. Procompetitive arguments for pay-to-stay fees point out that they help to allocate costs of shelf space between supplier and retailer, and that they serve to place products in prime locations such as at eye-level space on the shelf. An anticompetitive argument states that such fees exclude competitors from the market either by making entry more difficult or by cutting profitability. For example, a manufacturer might be paying the retailer a pay-to-stay fee to in effect "not carry" a new substitute product, another brand of a substitute product, or a private label product. The supplier might also offer to pay the fee in order to raise rivals' costs, with the intent of reducing the competition it faces and thus increasing market share and profits. If manufacturers of existing products succeed and wield their market power to outbid suppliers of new products, consumer variety will ultimately be reduced.

The argument in favor of cost-sharing through pay-to-stay fees stems from the notion that as retailing costs are increasing, some costs are more easily borne by retailers and others by suppliers. An efficient allocation would spread the costs to the party that could most easily bear them, and is most likely when the parties have equal bargaining power. If one party has a strategic advantage, however, the other might ultimately bear more than its appropriate share of costs.

Volume incentives and rebates. One frequently used fee is the volume incentive, a per-unit rebate directly linked to quantity sold. For example, a sales agreement might specify that a supplier will pay a rebate of 10 cents per carton for the first 1,000 cartons that the retailer buys, 20 cents for the next 1,000, and so on. From the procompetitive perspective, volume incentives serve to build long-term relationships between suppliers and retailers. Retailers' costs per unit decline as more units are purchased from the supplier, providing an incentive for the retailer to buy larger quantities from a particular supplier. Consumers benefit, however, if the decline in retailers' per-unit costs (wholesale prices) are passed on through reduced retail prices. At the same time, the larger volume may reduce the supplier's per-unit marketing costs, thus increasing their profitability.

An anticompetitive viewpoint is that the retailer may be demanding an unjustified per-unit discount from suppliers, potentially reducing suppliers' revenue below costs, and, in the long run, leading to an unsustainable situation that supports fewer suppliers. Another point of the anticompetitive argument is that even when per-unit discounts do not eliminate profits, discounts may reduce supplier profits and may drive some firms out of business.

Fees & Competition

Regardless of whether fees are considered the result of market power or of movement toward enhanced efficiency—i.e., whether they are anti- or procompetitive—the growing use of fees, especially in light of the record number of retail mergers over the past few years, has captured policymakers' attention. As early as the mid-1990's, the Bureau of Alcohol, Tobacco, and Firearms prohibited the use of certain fees for marketing alcoholic beverages. In 2000, the Senate Committee on Small Business held a hearing on fees, the Congressional Budget Office scrutinized fees, and the Federal Trade Commission held a workshop examining fees. Also last year, USDA's Economic Research Service conducted an in-depth study of fees in fresh produce marketing (see article on page 10).

Ultimately it is the Federal Trade Commission (FTC) or the Department of Justice that determines whether a pricing strategy is anticompetitive or violates antitrust legislation. According to FTC regulations, "a practice is illegal if it restricts competition in some significant way and has no overriding business justification. Practices that meet both characteristics are likely to harm consumers—by increasing prices, reducing availability of goods or services, lowering quality or service, or significantly stifling innovation." In some cases, a pricing strategy that appears at the outset to damage competition might be allowable if any detriment to consumers is outweighed by an efficiency gain, such as a better product or reduced costs.

Fees are becoming more common provisions in supplier-retailer transactions for many products and can have positive as well as negative effects on firms and consumers. Fees may raise supplier costs and wholesale prices, and lead to higher retail prices or reduced product variety. But fees may also increase competition among firms, and bring lower retail prices, a proliferation of new products, greater product variety, or higher quality products. The net effect of fees on consumers depends largely on the balance of benefits and costs in each specific case. AO

Carolyn Dimitri (202) 694-5252
cdimitri@ers.usda.gov

March Releases—USDA's Agricultural Statistics Board

The following reports are issued electronically at 3 p.m. (ET) unless otherwise indicated.

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2	Dairy Products Prices (8:30 a.m.)
	Dairy Products
	Egg Products
	Livestock Slaughter - Annual
	Poultry Slaughter
6	Weather - Crop Summary
7	Broiler Hatcher
8	Crop Production
9	Dairy Products Prices (8:30 a.m.)
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	Turkey Hatchery
16	Dairy Products Prices (8:30 a.m.)
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